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May 15, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Magalie Salas
Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Re: In the Matter of Federal-State Joint Board on Universal Service
CC Docket No. 96-45/CC Docket No. 97-160 and DA 98-715

Dear Secretary Salas:

Enclosed please find an original and five copies of the Comment on Proposals to Revise the Methodology for Determining Universal Service Support for filing in the above-referenced proceeding.

Also enclosed is an extra copy which I ask that you stamp as filed and return to the messenger.

Sincerely,

**BIRCH, HORTON, BITTNER
AND CHEROT**

Elisabeth H. Ross

Elisabeth H. Ross

cc: Chairman Kennard
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Commissioner Furchgott-Roth
Commissioner Powell
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MAY 15 1998

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)
Federal-State Joint Board on)
Universal Service)
_____)

CC Dockets No. 96-45/and 97-160,
and DA 98-715

**COMMENT ON PROPOSALS TO REVISE THE
METHODOLOGY FOR DETERMINING
UNIVERSAL SERVICE SUPPORT**

I. BACKGROUND

Several parties filed proposals in response to the Commission's invitation to file additional proposals concerning the methodology for determining universal service support. The Maine Public Utilities Commission, the Vermont Public Service Board, the South Carolina Public Service Commission, the Arkansas Public Service Commission, the West Virginia Public Service Commission, the New Hampshire Public Utilities Commission, and the New Mexico State Corporation Commission, believe that, based on the material submitted to the Commission, the Ad Hoc proposal¹ represents the best available approach to balancing the many important objectives of the Telecom Act.²

**II. THE PROPOSALS FOR HIGH COST FUNDING SHOULD BE EVALUATED PRIMARILY UPON
PRINCIPLES OF SUFFICIENCY AND EFFICIENCY.**

The Commission should evaluate proposals for universal service funding based primarily upon two principles: sufficiency and efficiency.

1. The Ad Hoc proposal was filed under a cover letter signed by Chairman Welch of the Maine Public Utilities Commission and Commissioner Dunleavy of the New York Public Service Commission.

2. Because some of the same issues discussed in this paper are in litigation, state commissions supporting this paper consider it a settlement offer, and they do not waive any rights to assert different interpretations of the Telecommunications Act of 1996 than those expressed here.

A. Sufficiency

The keystone of the Commission's high cost efforts must be to ensure that consumers in rural, insular and high cost areas have access to a similar spectrum of telecommunications services as consumers in urban areas, at rates that are reasonably comparable to rates charged for similar services in urban areas.³ Section 254 puts the obligation to ensure universal service squarely on the Commission. Subsection 254(e) refers only to federal support and states that eligible carriers are to receive federal support that is "sufficient to achieve the purposes of this section." The purposes of Section 254 [as listed in Section 254(b)] include making local phone service and other supported services "available at just, reasonable and affordable rates" which are "reasonably comparable" to rates "in urban areas."

It follows that, to achieve the sufficiency dictate of Section 254(e), the federal support provided must be enough so that rates in rural areas will be affordable and reasonably comparable to rates in urban areas. The Telecom Act requires that rates be "reasonably comparable," not only between urban and rural areas within a single state, but also between urban and rural areas in different states. This requires federal support for at least some high cost areas. Support mechanisms must be specific, predictable, and sufficient⁴ to allow rates to be affordable and comparable.

B. Efficiency

The high cost proposals submitted on or about April 27 demonstrate that the Commission will not be able to satisfy everyone's expectations about universal service. It is now apparent that the Commission is being asked to address four distinct problems, each of which is costly to solve. Yet there are significant practical limitations on the Commission's ability to raise funding. This means that the Commission must make "efficiency" an important goal in designing high cost programs.

The first problem identified in the proposals is on the state side of the ratemaking divide: the Commission must ensure that state rates are affordable and reasonably comparable. Proxy models

3. 47 U.S.C. § 254(b)(3).

4. 47 U.S.C. §§ 254(d), (e).

suggest that the cost of this task could be as high as \$8 billion, although since the Commission has not defined a proxy cost model or inputs, the amount is still uncertain.⁵

The second problem is on the FCC's side of the jurisdictional divide: removing some or all "implicit subsidies" from interstate access charges. As estimated by GTE, the cost of this would be \$6.2 billion.

The third and fourth problems, support for school and libraries and rural health care services, have been addressed by the Commission's earlier rulemakings. The following table summarizes the claims for or commitments to all programs for universal service support.

Support for State Rates	\$8 billion
Support for Interstate Access	\$6.2 billion
Schools and Libraries	\$2.25 billion
Rural Health Care	\$0.25 billion
Total	\$16.7 billion

This total cost of \$16.7 billion seems likely to be beyond the reach of what Congress or the Commission would consider acceptable. Such a system would impose a significant burden on the interstate telecommunications industry, and if levied solely on interstate revenues, could cause misreporting of revenues and arbitrage. Therefore, the Commission must find creative ways to limit the size of these programs, while still achieving the statutory ends. In other words, the Commission's programs must be "efficient" in achieving the statutory goals.

Of all the proposals submitted to the Commission, only the Ad Hoc plan fully satisfies these dual objectives. As described below, the other proposals either fail to satisfy the statutory mandate of comparability or fail to offer a practical and efficient approach.

5. This is the estimated cost of implementing a forward-looking model at a small geographic scale of calculation, such as the census block group, and it assumes revenue benchmarks of \$31 and \$51.

III. THE EXISTING HIGH COST FUND PROGRAM IS NOT SUFFICIENT.

Some of the parties filing proposals on April 27, such as Bell South, suggested that existing support payments for the benefit of the state jurisdiction should serve as the basis for future payments. By implication, these parties must believe the existing funds are sufficient. This is clearly not the case. There are inadequacies in the existing system as to loop cost, switch cost, and transport cost. In addition, the existing system was not designed, as the Telecom Act now requires, to ensure that rates in rural, insular and high cost areas are reasonably comparable to rates in urban areas. The result of the current funding system is that very rural states served primarily by "non-rural" LECs cannot have rates that are reasonably comparable to urban areas.

A. Loop Cost

The existing support mechanism for high cost loops is insufficient for companies serving more than 200,000 loops. The existing high cost fund provides support for loop costs (based upon the embedded unseparated cost per loop) above 115 percent of the national average. The incremental support for companies with costs in this range and with 200,000 or fewer loops is 65%.⁶ By contrast, the incremental support level for companies with more than 200,000 loops is 10%.⁷ The rules thus provide 55 percent less federal support at the margin for local telephone service costs in areas served by a large company. This discriminates against rural states that have high cost areas served by large companies.

For example, since Bell Atlantic serves over 200,000 access lines in Maine, Vermont and West Virginia, and since costs in these states exceed 115% of national average, Bell Atlantic in all three states receives less USF support than do the other smaller LECs in those states. In each of these states, Bell Atlantic's unseparated loop costs in these states is higher than the costs of several smaller companies in those states. Yet in Vermont, if Bell Atlantic were to receive federal support based on the more favorable small company formula, support would amount to \$3.29 per line per month, rather than the \$0.51 per line per month currently received. The shortfall is necessarily recovered from consumers in higher local rates or untenably high intrastate toll or intrastate access rates.

6. 47 C.F.R. § 36.631(c).

7. 47 C.F.R. § 36.631(d).

For this reason alone, the Commission should conclude that the existing system is not sufficient, at least in rural states served by large companies, and that ratepayers in those states cannot hope to achieve reasonably comparable rates.

B. Switch Cost

Separations rules use the interstate DEM factor in allocating switching costs. The rules permit small carriers to multiply their switching interstate minutes of use by a fixed factor ranging from 2.0 to 3.0. The result is that cost recovery is shifted from the state to the interstate jurisdiction. However, DEM weighting is available only to companies with less than 50,000 lines. It is particularly beneficial to even smaller companies, those with less than 20,000 or less than 10,000 lines.

The existing support mechanism for high switching cost is insufficient because it supplies support to small companies, not companies with small switches. The result is a program that is both over-inclusive and under-inclusive. It is under-inclusive because it fails to provide support to companies with high switching costs that have more than 50,000 lines. It is over-inclusive because it provides support to small companies with low switching costs that do not need support in order to keep rates reasonably comparable.

For example, under the existing support mechanism, a company having a single 20,000 line switch would receive DEM weighting support, but a company with one hundred small switches, each serving 500 lines, would receive no support. This defect in the existing support mechanism again penalizes those rural states with small switches that are served by a company with more than 50,000 lines. For example, Bell Atlantic companies in Maine and Vermont receive no switch support, even though switching costs per line in those states are among the highest ten states.

C. Transport Cost

The Commission does not have any existing program to provide support for high transport costs. While transport costs are generally smaller than loop and switching costs, this is not always the case. Indeed, in some areas trunking costs are larger than either loop or switching costs. The national average embedded trunking cost is \$41.50 per line per year. In New York and Massachusetts, average trunking cost approaches \$80, and in Hawaii, Maine, Vermont, and Wyoming trunking cost exceeds \$60. Yet none of these state receive any support for their trunking costs. If the Commission's new high cost program is to succeed in keeping rates reasonably comparable, it must take account of at least

those trunking costs that are essential to the provision of universal service. Since the incidence of these costs varies and is significant, high cost support programs must account for them.

D. Combined Effect

Inadequate loop support, poorly targeted switch support, and no support for transport costs combine to produce a pronounced effect on rates in some states. If embedded costs for loop, switch and transport are added together to produce a total "universal service embedded cost," the national average is \$406 per line per year. Yet numerous states have total costs well in excess of this average. Alaska's embedded cost exceeds \$600 per loop. Costs in Wyoming, Vermont and Montana exceed \$550. Costs in Arkansas, Maine, Mississippi, New Mexico and West Virginia all are in excess of \$500 per loop.

These three inadequacies, as to loop, switch, and transport, prevent the existing system from producing affordable and reasonably comparable rates. The Commission cannot overlook these problems in developing a new program under the Telecom Act.

It is no answer to suggest that large companies can draw on economies of scale to offset the higher costs of serving rural areas. This suggestion is contrary both to fact and to the Telecom Act. It is undisputed that some large companies have relatively few low-cost customers from whom to draw support for their high-cost areas. Since not all large companies start from the same place, intra-company rate averaging cannot produce reasonably comparable rates for customers of relatively high cost companies.

Moreover, the Telecom Act requires each state to facilitate local exchange competition. In passing section 254 of the Act, Congress recognized that this will drive prices to cost, driving out implicit subsidies in existing rate structures. Thus over the long run, the national policy favoring local competition will make it impossible for large companies to transfer revenues from their low-cost areas to their high-cost areas. Accordingly, the forward-looking cost models properly assume that no such transfers are possible. These models properly recognize that neither a large nor a small company is able to increase the efficiency of a switch that serves relatively few customers; nor can either company shorten long loops.

IV. OTHER FILED PROPOSALS CANNOT BE SHOWN TO PROVIDE SUFFICIENT FUNDING AND DISTRIBUTE FUNDS EFFICIENTLY.

A. Arizona

Arizona has filed comments suggesting improvements in support for line extensions. This appears to be a useful suggestion, but does not address the statutory requirement that federal funds be sufficient to ensure that rates in all parts of the country are affordable and reasonably comparable.

B. Bell South

Bell South suggests that the total amount of federal support remain constant. The jurisdictional separation of these funds is not entirely clear from the filing, but it appears that Bell South intends that funds now dedicated to reducing state costs, such as high cost funding and DEM weighting, would remain available to reduce state rates. Meanwhile other programs, such as Long Term Support, would remain on the interstate side.

To the extent Bell South is proposing that state support remain at the same level as existing funding, its proposal is not sufficient to meet the requirement for affordable and reasonably comparable rates.

Bell South also is proposing the restructuring of interstate revenue sources. That proposal is irrelevant to the statutory criteria of sufficiency and reasonably comparable rates. The filing parties have no comment on it, other than to observe that such a proposal has nothing to do with the purposes of section 254 of the Act.

C. Colorado Staff Plan

The Colorado staff has filed a general proposal describing factors that could be used to define a support plan. The proposed factors are the intrastate revenues of each state and the average support needed per line. While these factors are appropriate to consider in a federal support plan, the Colorado filing offers too little detail to determine whether the plan would meet the requirements of sufficiency and efficiency.

One apparent problem with the Colorado plan is that while it does anticipate states having shared responsibility with the FCC in making rates affordable, it does not take account of any state's

overall cost level. The result could be that federal support would be sent to states with low overall cost, and denied to states with high overall cost.

D. South Dakota and Ramsay Options.

It is not apparent from either the South Dakota or the Ramsay filing whether either of the two options described can achieve reasonably comparable rates at a reasonable total cost. The viability of both options depends on the detailed input factors considered in calculating the critical benchmark numbers (in the first option) or payment ratios (in the second option). It is also critical how these inputs and factors are combined, and how the jurisdictional traffic factor for each state is incorporated into the plans. Unfortunately, the lack of detail in the filings makes it impossible to evaluate whether these plans meet either the sufficiency or the efficiency standard.

E. US West.

US West's plan provides 100% federal funding for all costs exceeding \$50 per line per month. US West correctly recognizes that the FCC is not going to be able or willing to finance an \$8 billion federal high cost program. However, by raising the benchmark to make the program more affordable, US West has left ratepayers in some states with rates that will not be reasonably comparable to urban areas.

As the following table shows, if the US West plan were implemented, the results would be neither sufficient nor efficient.

Table 2.	State A	State B
Total Customers	100	100
Customer Distribution:		
at \$100 Cost / mo.	0	10
at \$45 Cost / mo.	100	0
at \$15 Cost / mo.	0	90
Total Cost / mo.	\$4,500	\$2,350
Average Cost / mo.	\$45.00	\$23.50

Table 2.	State A	State B
Total Customers	100	100
Federal Support / mo. (B/M = \$50)	\$0	\$500
Federal Support / Line / mo.	\$0.00	\$5.00
Unsupported Cost / mo.	\$4,500	\$1,850
Unsupported Cost / Line / mo.	\$45.00	\$18.50

The US West plan is not sufficient because it leaves customers in State A with no federal support, despite the fact that they have a uniform cost of \$45.00 per line per month. Rates in state A would not be reasonably comparable to urban areas. Even if State A were to enact a large state universal service fund, that fund could not reduce the high average cost of service in that state, and State A's ratepayers would continue to pay \$45.00 per month, in a different form.

The US West plan is not efficient because it provides support for State B despite the fact that ratepayers in State B, with a low average cost, are well able to generate support for their own high cost areas, without risking non-comparable rates. Rather than using federal support for State A, which has high average cost, US West would provide the support to State B, thereby reducing the already low net monthly cost of \$23.50 down to \$18.50.

E. GTE.

GTE correctly notes that the Commission must provide support for state rates. GTE states that the FCC:

should provide a reasonable amount of support to states, particularly those with high costs and/or low revenues. Federal support would help those states replace the implicit support that is generated today by state rates for services such as access, toll, and vertical features, and accommodate states that cannot eliminate implicit subsidies and still maintain affordable rates.⁸

GTE correctly identifies the two portions of the intrastate rates problem: implicit subsidies; and high underlying average cost.

8. GTE comments at 3, ¶ 2.

Unfortunately, GTE's comments also focus primarily on replacing "implicit subsidies" in interstate access charges. While the methods by which carriers recover their interstate costs is certainly a legitimate concern for the Commission, this is not the statutory purpose of high cost funding under section 254. The Commission should not confuse the new statutory purpose of high cost funding, affordable and comparable state rates, with its existing responsibilities over interstate access charges. Restructuring access charges may be useful and proper, but it should not be the driver of universal service reform.

GTE's multiple benchmark proposal is similar to that proposed by US West, and deficient for the same reasons. If a multiple benchmark approach is going to be used, the benchmark for any state or company should be based upon average cost, as was suggested by South Dakota and Ramsay in their first option.

V. THE AD HOC PLAN PROVIDES SUFFICIENT FUNDING WITH A MINIMAL FUND SIZE.

The details of the Ad Hoc plan, and the manner in which that plan meets the goals of the Telecom Act, are set forth in the proposal submitted on April 27, 1998 by Chairman Welch and Commissioner Dunleavy and are not repeated here. As the following synopsis shows, however, the Ad Hoc plan fully satisfies the test of sufficiency and efficiency.

A. The Ad Hoc Plan is Sufficient.

The Ad Hoc Plan would produce enough support so that no state would have average net costs higher than 105 percent of the national average. After this support is distributed, states would on the average have rates that meet the federal standard of reasonably comparable rates. As a matter of intrastate rate design, states can then ensure that rural rates within their states are comparable to their urban areas.

B. The Ad Hoc plan is Efficient.

The Ad Hoc Plan offers the FCC the opportunity to reduce the total program size implied by the proxy models. This is achieved in major part by separating the state rate management task into two parts, and assigning federal responsibility only where it is essential. The first task, dealing with high average underlying costs in a state, is suitable for federal responsibility; indeed it can be performed

no other way. The second task, replacing the implicit subsidies within state rates, is suitable for state responsibility.

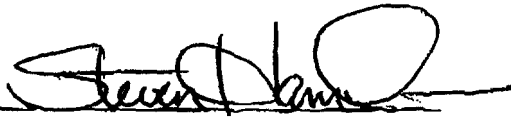
Under the Ad Hoc plan, the federal fund would be responsible only for funding state rates to the extent that the state itself is unable to finance its own needs. Once states are allowed to get to the same starting point, the states themselves would be responsible to raise support that responds to rate differences within their own jurisdictions. If federal funding pursuant to the first task is sufficient, this second task will be within the financial capability of all states.

The Ad Hoc plan suggests that states will want to balance the needs of their high-cost areas against the resources of their low-cost areas. This is fundamentally different from requiring carriers to generate such transfers. For carriers, as noted above, there are two problems. First, some carriers have relatively few low-cost customers and numerous high-cost customers. Second, in a competitive environment, carriers cannot be expected to maintain any implicit transfers that may exist today between customers. For states, however, the situation is fundamentally different. States have the authority under the Telecom Act to raise funds to support universal service. Indeed, this kind of explicit transfer is exactly what the Telecom Act suggests is the appropriate means to redress unreasonably large rate differences.

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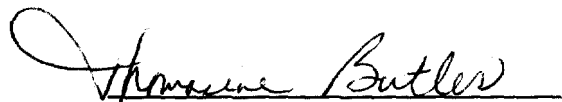
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I, Thomasine Butler certify that on this 15th day of May, 1998, I served "Comment on Proposals to Revise the Methodology for Determining Universal Service Support" on the parties listed on the attached service list by first class postage paid mail. The Federal Communications Commission officials and staff were served by hand delivery to The Federal Communications Commission.


Thomasine Butler

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